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Economic Conditions
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General Business Conditions

TWO great tasks face this country at the beginning of the new year. The first is to devote to winning the war every effort and every resource that can be so employed. The second is to make all possible preparation to facilitate the reconversion to peacetime work which will come as war demands on the industries decline, and which in a small way is already beginning. The reason why reconversion problems have become pressing while the war is still far from won is that we have found that we can produce more of some types of weapons and munitions than the armed forces can use. This leads to cutbacks in production schedules, which release materials and labor first to make other war products, and in due course to turn out more civilian goods.

Before the end of 1944 the release of materials and plant facilities for civilian production, which is now only a trickle, seems likely to become a good-sized stream. General Eisenhower has expressed himself without qualification as believing that the defeat of Germany will come during 1944. When that happens contract cancellations will rise to an enormous volume, even though war production must continue large until the defeat of Japan. Unless policies have been established and organizations enlarged to handle contract settlements promptly, and to deal with the related problems of disposal of inventories, machines and plant, the transition to peacetime manufacturing will be slow and difficult. Much of the industrial organization will be tied in knots, with working capital frozen in war inventories and working space encumbered with government property.

Other problems which call for policy-making decisions are also pressing. More materials, especially metals, are available and could be used for civilian goods to the extent that labor, plant capacity and component parts are also available. But questions arise as to whether some companies in a competitive field are to be allowed to resume civilian production while their competitors are kept on war work; whether standardized or "Victory" models are desirable for a time; what consideration should be given to manufacturers who want to make a new product; how prices should be established, and similar problems. These questions are beginning to be urgent and will become more so as the year goes on.

All these problems have been under study by government and private agencies. They are now in the competent hands of Mr. Baruch and his associates, who have the task of establishing policies and laying down lines of authority. Their purpose is to set up a program to avert needless confusion in the industrial organization, and if they can clear the way an optimistic view of conditions during the reconversion period will be justified.

The part of the problem which falls upon industrial management, namely, to resume making familiar things, is one which the manufacturers of this country are superlatively able to solve. Their record in converting to war work and turning out unfamiliar war products is sufficient proof.

Obligations of Individuals

Some comment is heard to the effect that the growing emphasis on reconversion tends to detract from the war effort. The argument is that it diverts thought and energy,— also that some people begin to take victory for granted, and consciously or unconsciously weaken their support of the war measures. The answer to the first point is that events make preparations for reconversion imperative, and the planning of the war effort has reached a point where it is feasible to take up new problems. If people become heedless or selfish, the cause in most cases is lack of leadership and understanding. Obviously, the obligations of individuals are not altered in the slightest, and there is no real reason why the greatest possible war effort, preparations for reconversion, and such shifts back to civilian production as war needs permit, cannot all be carried on successfully together.

FOURTH WAR BOND DRIVE BEGINS JANUARY 18TH

People have the duty in 1944, as they had in 1943, of doing more to help win the war. There is need for everyone to economize and save, to buy more government bonds, to work more effectively whether they are in war plants or civilian occupations, to co-operate more whole-heartedly in the ration and price control programs, and in general to subordinate their personal and group interests in greater degree to the common effort and the common welfare. Probably these points cover about what General Eisenhower had in mind when he referred to the "duty" of people back home, and what Secretary Hull meant when he called for national "unity".

The Production Outlook

The business observers who ventured at this time last year to make predictions for the year 1943 were generally agreed upon three main points. One was that industrial activity — governed by the supreme need to get ahead with the war — would rise again to new highs. The second was that prices would advance, perhaps considerably. The third was that consumer goods trade would fall off.

The first of these predictions has been realized, and the increase has been even greater than expected. Industrial production in 1943 has exceeded 1942 by 20 per cent, according to the Federal Reserve Board's index. The price advance, as measured by official indexes, has been substantially less than most people looked for. Wholesale prices during the year have risen 2 per cent and the cost of living only about 3 per cent. The decline in consumer goods trade has not materialized at all. Retail dollar sales have totaled some 9 per cent higher, and it seems probable that the volume of merchandise distributed, coming partly out of inventory, has increased as well.

This record shows that the capacity to produce "butter" as well as "guns", and the effectiveness of rationing, price controls and people's savings in restraining inflationary forces, were both underestimated. There may be a lesson in this for the coming year.

Looking into 1944, there are two reasons for thinking that the output of the industries is now nearly at its ceiling. One is that further increases in the manpower available, after allowing for the 1944 additions to the armed forces, are hardly to be expected. (To be sure, the productivity of the workers now employed should and may be increased.) The second is that the goals of war production, in the aggregate, have already been approximately reached. Mr. Lawrence Appley of the War Manpower Commission stated December 28 that war production was at the rate of $80 billions annually, and this is somewhat higher than the total of the schedules for 1944, even without allowance for later cutbacks. Mr. Wilson, Vice Chairman of the War Production Board, told the National Association of Manufacturers during the month that war production in 1944 must exceed 1943 by 20 per cent, but this was a comparison between the aggregates for the full years, not between the year-end rate and the 1944 schedules.

On the premise that the course of the war will permit curtailment of war production sometime during the year, the prospect is that total industrial production also will turn downward, for civilian industry will hardly take up all the slack. The time needed to swing smoothly back into peacetime operation and the difficulties — some of which have been touched on above — have to be taken into account. Also, it should be understood that the wartime level of industrial activity is wholly abnormal. It includes operation of many plants which will have no civilian use, and of many others which could be turned to civilian production only by extensive reconversion. The industries are employing many workers who after the war will want to go, and who should go, back into the homes, back to school, or into retirement.

The indications are that consumers in 1944 will fare in the aggregate about as they have done in 1943, with larger production of consumer goods later in the year but with smaller inventories in distributors' hands to draw upon as the year begins. However, if the rise in national income flattens out as the production increase tapers off, retail sales would be expected to flatten out also, and experienced observers doubt that the record-breaking totals of 1943 will be duplicated. In general, merchants are looking upon 1944 as a year in which there will be, at some time, a swing back toward more normal conditions. They look forward to getting, sooner or later, more durable goods and more of their accustomed lines and qualities in non-durable goods. They are likely to push sales of "substitute" goods accordingly.

Manufacturers have no way of knowing whether some part of their plants will be freed for peacetime work in the middle of the year, at the end of the year, or at all. However, a disposition to keep down inventories of materials, except those which are allocated to specific government contracts or which can be used in peacetime work, is evident. It seems plain that when the cutback in war production comes, stocks of industrial raw materials will be heavy in almost all lines, and behind the stocks will be an enlarged producing capacity to fill all needs abundantly. This makes hoarding of materials in general unattractive. During the past month the freeing of pig iron from allocation control, cutbacks in aluminum production, end of Sunday work for copper miners, and the announcement that a program for the

liquidation of the government-owned stock of foreign wool is in preparation, have provided additional evidence of the easing in raw material supplies.

The Labor Crisis

The threatened railway strike December 30, which would have paralyzed the war effort, has been averted by an award to two of the operating unions of wage increases fixed by the President personally, and by his action on the 27th seizing the railroads and placing the Army in control. The wage award, which presumably will be extended to the other operating unions, departs from previous policy in the same three respects that the award to the United Mine Workers at the beginning of November departed from it. First, in terms of what the employees will actually receive it goes beyond the Little Steel formula, under which wage rate increases are in general limited to 15 per cent since January 1, 1941. Second, in making the award the government agency vested with authority over the case was over-ridden. Third, while the award was not actually made to end a strike already begun, as in the coal miners' case, it was made to avert one which was imminent, which is not greatly different. The policy of refusing to sanction wage increases to workers on strike, long adhered to by the War Labor Board, was correct in principle, even though the attitude of powerful unions has made its observance very difficult.

Now that established policy has been voided in two major cases, the probability that other unions will invoke the strike weapon unless the Little Steel formula is broken for them also is of course apparent. Steel workers already have given an example by stopping work while new wage contracts were under negotiation, because the War Labor Board voted against directing that any increases they might obtain would be retroactive to the expiration of the old contract. Thereupon the Board, taking a new vote, reversed itself. Thus new contracts will be retroactive, although any increase in steel prices which the O.P.A. may grant cannot be retroactive; and the steel unions have additional reason for feeling that they have on their side the strength to drive a stiff bargain. The cost of the stoppage to the war effort was 170,000 tons of steel.

In the offing are the demands of the powerful clothing workers' unions and others for wage increases going beyond the Little Steel formula. It is naturally to be expected that every concession will make more concessions necessary, until advances in industrial wages become general.

All this adds up to a new labor crisis. There is little occasion to go over again the statistics of wages, cost of living and other data bearing on the unions' claims that wage scales are inequitable, on which comment was made in the last issue of this Letter. The facts of broader importance are, first, that at the demand of groups ruthless enough to threaten to paralyze the war effort, the anti-inflationary program is being weakened and an increase in labor costs set in motion which in due course must lead to price increases; and second, that strikes and strike threats instead of being penalized are rewarded, which encourages more strikes.

Overthrow of Established Policy

The conflict that has thus been allowed to develop is not between labor unions and employers but between labor unions and the Government, and blame attaches to both sides. As far as railways are concerned, mediation procedures generally considered to be models of their kind are established by law. They were invoked in the present cases, but not carried through to completion. A Presidential Emergency Board awarded 4 cents an hour increase to the operating unions, which the union leaders described as an insult. A similar Board awarded 8 cents an hour to the non-operating unions but Stabilization Director Vinson forbade the increase and a second Board was appointed which recommended a different settlement, with sliding scales. Meanwhile Mr. Vinson's action was rebuked by the Senate, which passed a resolution declaring that the 8 cents an hour was in conformity with the Railroad Labor Act and was not inflationary. Finally comes the action of the President taking matters into his own hands.

The record is one of conflicting authority and overthrow of established policy, carried on until it now seems fair to say there is no longer a governing formula, but only a situation in which wage cases will be dealt with separately, "each according to its merits." Under such conditions the government agencies, instead of having unquestioned jurisdiction, stature and prestige, tend to become arbitrators or mediators, subject to appeal to higher authority, to the exercise of the influence of the unions in political channels, and finally to the strike weapon. The opening of the gates to such pressures can hardly fail to lead to their use on an increasing scale, with consequences that can be immensely costly to the war effort.

The second disturbing element is the extent to which the labor leaders themselves are willing to press their demands. It is safe to say that members of the unions are good American citizens, as good on the average as other population groups, with about the same percentage of sons and relatives in the armed forces, and with as great an interest as others in speeding the war effort. But they have their eyes fixed on money wages, disregarding the other ele-

ments which govern the standard of living; and evidently they do not understand the importance of wage and price stability during the war and in the post-war situation. They rely upon their leaders. Yet the statements of the officials of the five operating brotherhoods in support of the railway strike call included assertions which could not be more inflammatory if they were deliberately intended to provoke disunity and encourage disorder in industrial relations. Samples of these assertions are the following:

> It is a strike against inflation for the privileged few and deflation for the many . . .
>
> All the frantic and cheap appeals to patriotism issued by the Offices of War Mobilization and War Stabilization cannot obscure this issue . . .
>
> We do not believe that American boys are fighting to defend politicians in office and profiteers in business and industry who are plundering their fathers and mothers and wives and children while they are away in uniform.

Such unwarranted assertions are harmful to the war effort and a disservice to the labor cause. This country's enemies in the war are totalitarian countries, which do everything by compulsion; but the American way, which is followed in mobilizing labor for war work, is to rely primarily upon voluntary cooperation. Reliance upon cooperation, however, assumes that people understand the necessity for teamwork and the position they must play on the team, and that they are willing to live up to their obligations.

The Seizure of the Roads

The seizure of the railroads by the Government has little in common with the corresponding move by President Wilson in December 1917. Then lack of coordination in traffic movements, with other factors, had caused such congestion that inadequate transportation service was the bottleneck of the whole war effort. The government action was for the purpose of establishing coordination and control by a central authority. No such condition has arisen in this war. On the contrary, the accomplishment of the railroads commands the admiration of the country.

President Roosevelt's move was for the purpose of putting the railway unions in the position of working for the Government, thereby subjecting them to penalties against strikes, and to put the roads under the protection of the Army both for security and to aid in operation if necessary. The President instructed that the ordinary management, operation and financial transactions of the roads were not to be disturbed except in such manner as necessary to secure the purposes of the order. The natural deduction is that a return of the roads to their owners is contemplated as soon as labor relations become stable again, following the parallel to be found in the taking over of the coal mines earlier.

The Fourth War Loan

The Fourth War Loan drive for $14 billions will start at a time when there is increasing activity on many fighting fronts and when the United Nations' plans for the invasion of Europe are shaping up rapidly. Preparations for the government security sale are being perfected by the War Finance Committees of every state, and call for a more extensive canvass of investors than was made in any previous campaign. The various types of securities to be offered, as announced more than a month ago, are already familiar to the public and are the same as in the third drive, except that in place of the 10-year 2 per cent bonds there will be 13/16-year 2¼ per cent bonds.

The aim of the Fourth Loan is to broaden still further the sale of securities to investors outside of the banks, and particularly the sales to individual investors. A quota for such sales has been set at $5½ billions, compared with a goal of $5 billions and actual subscriptions of $5.4 billions in the third drive.

Commercial banks having savings deposits, however, will be permitted to participate in subscriptions to the 2¼ and 2½ per cent bonds, and to series F and G savings bonds, to an aggregate up to 10 per cent of such savings deposits, or up to $200,000, whichever is less. No bank, however, may hold more than $100,000 (issue price) of 1944 F and G savings bonds combined.

A summary of the amounts raised in the three previous war loans from the major groups of investors is given in the table following, which shows also the net increase in

Subscriptions to First Three War Loans, and Net Increase in Investor Holdings of U. S. Gov't Securities for Eleven Months Ended September 30, 1943
(In Billions of Dollars)

	First Drive 11/30/42-12/31/42	Second Drive 4/12/43-5/3/43	Third Drive 9/9/43-10/2/43	Total Three Drives	Net Increase 11/30/42-9/30/43
Insurance companies and savings banks	$ 2.3	$ 3.6	$ 4.1	$10.0	$ 6.3
Individuals, partnerships and personal trust accounts	1.6	3.3	5.4	10.3	
Other nonbank investors	2.8	5.6	7.9	16.3	24.9
Dealers and brokers	0.9	0.5	0.9	2.3	
Govt. agencies and trust fund	0.3	0.4	0.6	1.3	4.1
Nonbank subtotal	7.9	13.5	18.9	40.3	35.3
Commercial banks*	5.1	5.1	....	10.2	22.5
Federal Res. Banks**	....	....	....	....	3.5
Total	$13.0	$18.6	$18.9	$50.5	$61.3

*Commercial banks were excluded from the third drive, but were later sold $3.2 billions of bonds and certificates; in each of the two previous drives the allotments to banks were limited to about $5 billions. Between drives there were two certificate and one note offerings aggregating $3.2 billions new money (net of maturities) taken to a large extent by the banks.

**Federal Reserve Banks were not included in the drives.

investor holdings for approximately the period covered by the three loans. These figures are of interest as indicating the extent to which subscriptions reported during the drives represent actual net increases in holdings of government issues by the various groups, and to what extent the gross subscriptions to new issues are offset by disposal or redemption of other securities.

In comparing the figures of subscriptions during the drives with the growth of investor holdings of government securities, some allowance needs to be made for the fact that the latest data on ownership, as reported or estimated by the Federal Reserve Board, are as of September 30, whereas the Third War Loan did not close until October 2, with war savings bond sales up to October 16 being counted as part of the drive and with insurance companies having the privilege of deferring the payment and delivery of securities up to November 1. This overlapping at the end of the third drive, however, is not large enough to destroy the usefulness of the comparisons.

It will be seen that the increase in total interest-bearing debt during the eleven months period was some $11 billions more than the total subscriptions credited in the three drives. This was due to special offerings between drives, to the continuing regular sale of war savings bonds and tax notes, and to the direct issues to government trust funds.

In some of the investor groups, however, the net holdings increased less than the total of subscriptions during the three drives. In the case of the insurance companies and savings banks, for example, the net increase amounted to but $6.3 billions, against total subscriptions of $10 billions. Between drives these institutions rearranged their portfolios by disposing of certain of the older issues of government securities, as well as various other investments, thus paving the way for larger subscriptions to new issues than would otherwise have been possible.

For the next three investor groups the net increase in holdings was $4 billions less than the total subscriptions, despite the fact that the holdings reflect not only the subscriptions during drives but the net purchases (over redemptions) of war savings bonds and tax notes between drives. Purchases by dealers and brokers of course were for later distribution to others.

It is not surprising that during a great nationwide sales campaign, when everyone is trying to make a record and there is patriotic appeal to buy up to the limit, many purchasers will overestimate their ability to carry the full amount of their commitments. So long as the "lightening-up" by such purchasers following the drive does not become excessive, the overall results can still be considered satisfactory. Some buyers have obtained bank loans to assist them in financing relatively large subscriptions, with the expectation of reselling at a profit on the establishment of market trading.

Bank Holdings of Governments

It will be seen from the table that during the eleven months period the government security holdings of the commercial banks, in contrast with the showing of nonbank investors, increased by $12 billions more than the amount of their subscriptions during the drives. This large difference is accounted for by, (1) the offering between drives of two new issues of certificates and one of notes, taken to a large extent by the banks; and (2) the bank purchases in the open-market of substantial amounts of government issues, including both old and recent, which had come into the market from dealers and brokers as well as from institutional and individual investors.

The Federal Reserve Banks were not included in the drives, but during the same eleven months period increased their government security portfolio by $3½ billions. This absorbed securities sold by other investors and carried out the policy of keeping the market spppplied with funds, through replenishing the excess of bank reserves that was being continually drained away by the wartime expansion of currency and bank deposits.

To the extent that investors resell their government securities, or turn them in for redemption, and that such securities must be repurchased or refinanced by the banks, the objective of keeping down an inflationary expansion of bank credit is defeated. For this reason, it is important not only to sell the major portion of the new securities to be offered this year outside of the banking system, but also to have the purchasers hold on to their securities until maturity whenever possible.

Gold in the News

Several items pertaining to gold have appeared in recent weeks in the daily press. The reports of official sales of gold to hoarders in India and Egypt at premium prices have aroused particular public interest. A dispatch from Moscow quoted a Russian publication as advocating use of gold currencies in settling international payment balances after the war. The third item, the U. S. Treasury report that our gold stock declined in December to approximately the $22 billion level, serves as a reminder that gold shifts are continually taking place, and that gold is still performing its traditional function as a medium for settling international transactions.

General uncertainty brought about by the war has enhanced the attraction of investment

in gold as a means of protection against loss of the purchasing power of paper money. Despite scorn heaped by the Axis Powers upon the use of gold, demand for the metal picked up after the fall of France, and prices in free markets began to rise beyond the $35 per ounce level set by the U. S. Treasury. Prices have differed widely from market to market. The bulk of transactions was probably small, and everywhere gold coins commanded additional premiums because of easier transportation, handling, and disposal.

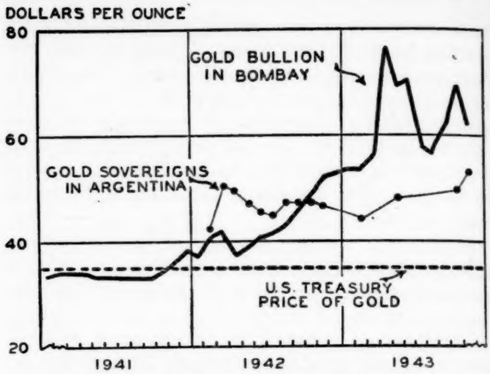
The official sales of gold to the public are a more recent development. Their primary object is to check inflation. In many parts of Latin America and Asia, where the masses of the people are not accustomed to use of banking facilities, or where the system of taxation is inadequate, sales of gold offer a means of absorbing excess purchasing power.

A few months ago the Mexican Government began to coin gold and silver pieces to attract the redundant funds in the country and to curb speculation. In India, where previously a committee headed by Professor T. E. G. Gregory, economic adviser to the Indian Government, recommended the sale of both gold and silver as a way of inducing the farmer to sell his produce, the Government started to release gold to the Bombay bullion market early in October and a few weeks later the Egyptian Government followed suit in Cairo.

One of the factors that has contributed to the disastrous shortage of food in various parts of India has been the tendency on the part of cultivators to hold their products off the market. Always distrustful of paper currency, the peasant has wanted goods rather than rupees, the purchasing power of which has declined by almost two-thirds since the outbreak of the war. The great expansion of rupee circulation, from about 2 to almost 8 billions, has naturally aggravated his distrust of paper currency.

The trend of gold prices in the Bombay bullion market will be seen from the accompanying chart. The peak of $77.25 per ounce was reached last May just before the Indian Government launched a series of anti-inflationary measures. Among others, loans on gold bullion were prohibited and restrictions were placed on forward dealings. The object was to reach the ultimate saver or hoarder who would pay cash. For the same reason, gold is being supplied in small bars — in Egypt weighing about 2 ounces and in India as low as three-eighths of an ounce.

Following the official tender of gold on the market, Indian bullion prices declined somewhat and late in November were at about the equivalent of $63 per ounce. In Egypt the Government was getting the equivalent of about $66 per ounce, but at that price the de-



GOLD PRICES IN THREE MARKETS
(Bombay quotations at end of month and Argentine quotations available only at irregular intervals)

mand is reported to be smaller than generally expected. The weekly sales in Bombay were put at about $1,200,000 early in November. According to the London Economist, the gold offered in India is apparently newly-mined metal from South Africa, since the gold stock in the Indian Reserve Bank remained unaffected.

Gold is bringing lower prices outside of the Near and Middle East. In Buenos Aires, gold bars apparently have fluctuated this year between $37 and $44 per ounce. However, as will be seen from the chart, gold sovereigns have brought considerably more — from $44 to $52 per ounce. In Mexico the 50 peso gold coins command a premium of about 10 per cent, equivalent to about $38-39 per ounce. The premium is less for smaller denomination coins.

Russian Intentions About Gold

The dispatch carried by the Associated Press December 6 from Soviet sources concerning gold quotes from a Russian magazine as follows:

> As a country which participates in foreign trade the Soviet Union, like England and the United States, is interested in the stability of currencies in those countries with which it carries on trade relations.
>
> If Soviet trade with other countries could be conducted in gold currency, undoubtedly this circumstance would facilitate trade operations.

This statement, which could hardly have been made without the approval of the Soviet Government, is significant as to the Russian attitude on the general problem of post-war currency stability. Just how much should be read into the statement that gold be used in settling international transactions must at best await future developments. While Russia has given evidence of willingness to cooperate with other United Nations, her state control of currency and foreign trade seems quite clearly to rule out adoption of anything like the conventional gold standard. What may be nearer to the reality is that the Soviet Union is ready

to back up the use of gold in international transactions and that she is interested in maintaining the value of gold, if only for the reason that she is likely to resume the position of second largest producer of the metal after the war. The statement is also a recognition of the value of currency stability in promoting trade.

Russia undoubtedly intends to make use of her gold in the rehabilitation of the country, but whether she will receive gold in return or build up large monetary stocks remains to be seen. In the past Russia regarded — as perhaps no other country did — her imports of commodities as the real gain in foreign trade, and her exports, whether gold or commodities, merely as the means of payment for the imports.

U. S. Gold Stock and Production

Our steadily declining gold stock, now about $800 millions below the peak of $22,800 millions reached a few weeks prior to Pearl Harbor, reflects principally the excess import balance in our cash foreign trade. Cash payments for excess imports are now running at the rate of about $600 millions a year, and the bulk apparently is going to individual Latin American countries. This in turn is being reflected in the phenomenal growth of Latin American gold and foreign exchange balances which increased during the first nine months of this year by some $700 millions, to over $2,000 millions.

If our new production and our imports of gold are considered, the overall loss during the past two years has been probably nearer to $1,300 millions than to $800 millions. Most of the metal itself remains in this country, in the earmarked stock held by the Federal Reserve Banks for the account of foreign central banks.

"Where's the Money Coming From?"

In the December issue of this Letter we devoted considerable space to a discussion of the general theory of government versus private spending, and in particular to the doctrine propounded by a certain school of economists that a rising public debt is not a matter of much concern so long as "we owe it to ourselves." We endeavored to show the difference in the economic effects of public and private debt increases, and to point out why a big national debt contains elements of danger and is almost certainly a burden and handicap.

About the time of our going to press on our December issue, announcement was made through the press of a new book carrying the title headlined above, by Stuart Chase, and published under the auspices of the Twentieth Century Fund. In this book, written in the engaging style for which the author is renowned, Mr. Chase gives full support to the "owing it to ourselves" argument about internal debt, and plumps unreservedly for the theory of the compensatory economy — that is, where the government takes responsibility for maintaining full employment by spending freely and running into debt in periods of depression, and siphoning off purchasing power and retiring debt by taxes in periods of boom.

The war has demonstrated, Mr. Chase argues, that the country can, if it only makes up its mind to do so, lift employment, payrolls, and production to peak levels. (The trouble with pump-priming in the 'thirties, he says, was that the government never spent enough). After seeing that the government can spend money all out and put people to work for war, Americans, he observes, are going to be hard to convince that the government cannot do the same for peace.

These are familiar assertions, — none more so than the last, viz., that because the government has spent lavishly in war it can "afford" to spend lavishly in peace. Mr. Chase may well be right in his estimate of public psychology on this point (though possibly he may not, as the huge wartime rise of debt and broadening of the tax base to include millions of new taxpayers may have a more sobering influence than he thinks). The fact is, however, that prediction and argument are two different things; and just because people do a certain thing does not necessarily make it right.

The New Theory of Government Spending and Debt

Discussing in his new book the question, where the money to support government spending is coming from, Mr. Chase says:

> The question of where's the money coming from has one answer in the case of the individual, and quite a different answer in the case of all individuals united in a nation. As in the matter of debt, it is meaningless to identify the individual with the nation as a whole. That kind of thinking leads into a blind alley. If you have no money, you cannot buy that beautiful new car. Period. But if you, and all your fellow citizens, want to buy a beautiful new river development project or a beautiful new war, there is nothing to stop you from doing so. What you can "afford" moves into an entirely new dimension.
>
> In your collective capacity you can put men and machines hitherto idle to work. When this pool is exhausted, you can transfer manpower from making cars to making tanks. You can issue claim checks (money) for the new war production, and then tax them back or borrow them back in a closed circuit. You can buy your war and its costly equipment right up to the limit of the nation's manpower, machine-hours and materials. There will be no difficulty about the money — as there is none today in any belligerent nation.
>
> . . . Except for our fears and financial traditions, the same formula can be followed in peacetime.

Analyzing this argument, it will be seen that it comes down basically to the same philosophy as that embodied in the statement that we need not worry about a national debt that is "owed to ourselves." Inasmuch as we discussed this latter theory at considerable length in the previous issue of this Letter, we shall not undertake to repeat at this time, but will merely point out that while we may as a nation "owe the debt to ourselves" this is not true of us as indi-

viduals. As individuals, our interests as taxpayers and bondholders are of the most diverse character; and it is precisely this diversity of interests among individuals that makes most of the trouble about public debt and taxes and frequently leads to serious consequences.

In the passage cited above, the author appears to assume a smooth, almost automatic, flow of funds from the Treasury through the processes of production and distribution and back to the Treasury by way of taxes. "You can," he says, "issue claim checks (money) for the new war production and then tax them back or borrow them back in a closed circuit." As he says in another passage following the quotation, "the money follows the work, and the taxes follow the money." And, according to the author, "except for our fears and financial traditions, the same formula can be followed in peacetime."

This argument is obviously similar to the National Resources Planning Board proposition that "costs and income are just opposite sides of the same shield," discussed in our December issue. The process sounds easy and simple; the difficulty is that funds do not flow from the Treasury into the economy and back to the Treasury in the smooth and automatic way that is suggested. While a certain amount of increased revenue will of course result from the stimulation of incomes and business activity, it is generally recognized that government spending means either bigger and bigger deficits or higher and higher taxes.

This raises the exceedingly knotty problem of who is going to pay the taxes. As we have had ample opportunity to observe in enacting our war tax program, few subjects are more controversial and more certain to arouse bitter antagonism than taxes. As taxes go up, people resist further increases, which means — if the spending continues — more borrowing and inflationary pressure. On the other hand, to the extent that taxes *are* stepped up, the effort of all groups is to shift the burden to other shoulders, thus enhancing the difficulty of achieving a fair and equitable distribution of the tax burden and avoiding repressive effects upon the economy.

In other words, the "formula" for "where's the money coming from" appears on analysis to be less simple than it sounds. Evidently there are reasons other than mere "fears" and "financial traditions" to be considered. Discussing the thesis that government spending and building up of debt need occasion no concern because the money spent or paid out in debt interest "remains within the system," Dr. Albert Hahn, former chairman of a large provincial bank in Frankfurt-on-the-Main, Germany, writing in The Banking Law Journal for July 1943, points to some interesting similarity with arguments circulated in Germany during and following the first World War. He says:

> To everyone who lived through the German inflation, this argument arouses strong, but very unpleasant, memories, for it is obviously identical with the dictum formulated in Germany during the first World War, — "The money remains in the country" (Das Geld bleibt im Lande). This dictum provided the solace to the conscience of German authorities as they followed the lax fiscal policies which resulted in inflation and the misery that came in its wake.
>
> But what of the statement itself? Is it true? It is not only true — it is too true. It is a truism like the arithmetical equation that ten minus ten equals zero. This argument, of course, can be applied at whatever level of government debt one might choose to mention, anywhere from $1.00 to trillions and trillions.

The Theory of the Compensatory Budget

The theory of the compensatory budget—or compensatory economy, as Mr. Chase puts it—has gained a wide following over the past decade. It is a product both of the depression and incomplete recovery of the 'thirties and of the boom generated by the war spending of the 'forties. As such, it represents a mixture of economic defeatism born of hard times, and of an exhilarating sense of having discovered something new from the experience of seeing at last what really big scale government spending can do. Adherents of the theory range all the way from the "mature economy" school, and those who for other reasons have lost faith in the self-propelling forces of the economic system, to those who are merely impatient with the slow and imperfect working of these economic processes. Regardless of such differences, all however share in common the view that it is the government's job to keep the economy operating on even keel at full employment, injecting purchasing power into the System by increased public spending and "investment" as private spending and investment falls off, and following a reverse course as the cycle changes. Implementing government spending, Mr. Chase advocates a highly "flexible" tax system—one designed to penalize "idle money" and drive "hoarded" savings into spending or investment when the economy needs stimulating, with a shift over to some form of spendings taxes when things begin to go too fast and need restraint.

Admittedly, here is a very interesting blueprint for permanent prosperity—if it would work. Actually, it is difficult—even with the most sanguine stretch of the imagination—to see how it could work.

In the first place, it is impossible to turn public expenditures and taxes on and off like the spigot of a water pipe. Much less is it easy to alter on short notice the structure of the tax system at the behest of economic planners bent on using it as the lever to control business cycle fluctuations.

While it is usually easy enough to expand government expenditures—appropriation bills

are almost invariably popular—it is quite another matter to contract them. Big public spending generates vested interests both within and without the government in continued big public spending. In periods of expansion the government becomes encumbered with all kinds of excess personnel, agencies, departments, and what not, whose ideas as to their indispensability extend far beyond the termination of the original emergency. Similarly, people on the outside who have been the recipients and beneficiaries of the government's largesse can seldom bring themselves to see any good reason why the flow from the Treasury should be cut off. As the saying goes, "Who wants to shoot Santa Claus?" The result is that every period of big spending leaves the government on a permanently higher level of costs, with more debt and more taxes.

And comparable difficulties arise as to taxes. While plenty of people like to see government expenditures increased, nobody really likes to see taxes go up. Yet it is implicit in the compensatory budget theory that taxes be increased promptly and vigorously to draw off purchasing power and retire debt as a brake upon inflationary tendencies. What are the chances of this weapon being employed effectively? A candid facing up to the lessons of our wartime tax experience is hardly encouraging. Despite the most compelling reasons for tax increases in wartime, both to pay for the war and to sterilize surplus purchasing power, we have witnessed the spectacle of months of wrangling over tax bills; and not even yet have we a tax program that is truly anti-inflationary in the sense of going to the heart of the problem of reaching excess income where it is being created. True it is that there have been very stiff taxes upon the medium and higher bracket individual incomes and upon the corporations, but there has been relatively little done to mop up the inflationary money which has shown itself so clearly in excessive and unnecessary spending. While there has been a lot of talk about sales taxes, spendings taxes and other types of taxes to meet the situation, between the Administration on one hand and Congress on the other, politics has dominated.

If we are unable or unwilling to tax adequately in wartime, when the need is so clear and when there is a spirit of patriotism to help, what chance would there be in ordinary times of raising taxes on large masses of people to cut off a perfectly good boom which everyone was enjoying and would doubtless like to see continue indefinitely?

Mr. John Chamberlain, literary critic of the New York Times, expressed the difficulty very well when, in reviewing Mr. Chase's book, "Where's the Money Coming From", he said:

> What bothers me is the failure of people to see the implications of Mr. Chase's ideas. If there is to be deficit financing in a 1933-39 period, there must be high taxation in a 1940-43 period, when the economy is booming. Yet Congress, at the moment, shows no willingness to tax with any rigor. I suspect that this is an almost unchangeable fact of human nature, this unwillingness to pay off in good times what has been borrowed in bad times. When it's raining is obviously no time to mend the roof. But when the sun comes out we don't want to mend the roof either. Things are too pleasant on the ground.

The difficulty was also expressed aptly, though more cynically, by the veteran Congressman who was reported to have advised the freshman member that the way to have a long career in Congress was "never to vote against an appropriation bill and never to vote for a tax bill".

Mr. Chase concedes in his book that his system would require a "serious psychological adjustment" about taxes. "Americans", he says, "traditionally regard taxes as a burden and a waste, if not an outrage." But, says he,

> . . . if they want a compensatory economy and not something much more radical, they will have to change their ideas and begin to think about taxes the way they have been taught to think about insurance. You pay now in order to avoid calamity later.

Perhaps Americans ought to think about taxes that way; but will they? Maybe, before piling up a lot of debt on the compensatory spending theory, it would be a good idea to know.

Deficit Financing No Cure

A second, and even more basic, objection to the compensatory budget idea is that it vastly over-simplifies the problem of maintaining economic stability. It would be a fine thing indeed if all that was needed to keep the economic machine hitting on all cylinders at just the right pace would be turning on and off the stream of funds from the public treasury. But it would be well to pause and think a moment of the full implications of this doctrine.

What it means, first of all, is applying a single specific — government spending — to all the ills to which the economic system may fall victim. No need to bother about the particular cause of the trouble — whether it be some basic disturbance or unbalance in vital parts of the economy. No need to bother whether exorbitant demands of particular groups are blocking the channels of trade; no matter about international trade barriers, or wrong exchange rates, or bad tax laws, or other short-sighted actions and policies of individuals and governments which, in varying degree, may be responsible for interrupting the even flow of economic activity. For all these, the prescription is the same —more government spending.

What it means, secondly, is attempting to shift to the government responsibilities that in a democratic society must rest primarily with the people. Putting everything up to the gov-

ernment means weakening the responsibility of the individual. Why should individual groups concern themselves with making adjustments, or place restraints upon their actions? The lid is off for pressure groups, whether they be labor, business, agriculture, or any other, if the government is responsible for keeping everyone employed. Why should anyone worry when the government underwrites everything?

The fact is that society cannot function under a system that encourages irresponsibility and indiscipline, and which protects everyone from the consequences of making mistakes. This is not to suggest "putting on the hair shirt" deliberately for the sake of punishment, but simply that necessity is the mother not only of invention but of adjustment. Except as there are incentives and pressures to eliminate sources of disorder, sore spots in the economy tend to get sorer and sorer, until finally the treatment breaks down as after the last war when a maladjusted international situation was masked and propped up by a huge volume of international credits.

An instructive light is thrown on the compensatory budget question by the following description and analysis of conditions in this country in 1920, just after World War I. The quotation is from a recent booklet* published by the National Bureau of Economic Research, a non-partisan organization of highest standing, whose directorate includes representatives of business, banking, agriculture, labor, and education; and it raises a question how the compensatory budget system would have worked had it been in operation at that time.

> Considering the nature of the eventual crisis, its international as well as domestic basis, it could hardly have been avoided by any makeshift policies of business, banking and government, conceived and applied at the moment.
>
> Unfortunately, business departures from prudence in commitments to buy and sell, in inventory holdings, and in short-term business debt had gone too far in too many cases. Furthermore, the participation of manufacturing and trade concerns in the speculative excesses of the period was widespread; in certain industries — of which automobiles, textiles, rubber, paper, retailing and wholesaling were outstanding examples — financial overextensions were numerous and conspicuous. Orders for goods were too often placed and accepted with reckless disregard for the responsibilities involved. The ultimate liquidity of too many debt commitments, however consistent with customary practice and with the commercial credit theory underlying the newly established Federal Reserve System, was solely dependent on impending transactions at the inflated level of prices then prevailing; in other words, too few concerns took sufficient account of their future capacity to retire debt from funds retained from operations in case short-term market expectations failed to materialize.
>
> Lastly, too many business creditors and debtors were unprepared to make debt adjustments once financial crisis was at hand; too few of them had anticipated the possibility of such crisis, and too few debtors had refunded excess short-term debt in time, or converted it into equity. In brief, businessmen, bankers, and public officials had simply raised their sights on the future too high and in so doing had overlooked immediate realities. Nothing except a different set of post-war business expectations, a less ambitious scale of business planning and stricter adherence to older standards of financial prudence could have altered the result.

Apparently, under the compensatory budget theory, the attempt should have been made to shore up this shaky and unsound structure by a great expansion of government spending. While it is possible that steps might have been taken to soften somewhat the severity of the deflation, can anyone question that a serious effort to hold the boom levels through deficit spending would have failed, and the crash been all the greater when it came?

No doubt some one will say that had the compensatory budget system been in effect the boom would have been prevented in the first place. But that is highly problematical, to say the least. Of course it has always been known that the best way to avoid depression is to avoid the booms that go before — but that hasn't prevented us from continuing to have both.

The Theory That Because We Can "Afford" to Spend for War We Can "Afford" to Spend for Peace

The argument that because we willingly pour out great sums to win a war we can do the same in peace is by no means original with Mr. Chase. It has been repeated off and on in recent years, and appears to be regarded by many people as settling the debate.

It is true, as Mr. Chase says in the first quotation cited above, there will be no difficulty about raising the money. The mechanism of the banking system and of credit expansion can take care of that. The real question is, what are the consequences of this kind of finance?

As Mr. Chamberlain observes in his book review, Mr. Chase has given up the idea of operating an economy by force, yet stands entranced at the war construction records of the belligerent nations. "Where did the money come from?" asks Mr. Chase, pointing to the vast military programs of Russia, Italy, Japan, and Germany. "Where did Britain and America get it for their colossal war outlays?"

We know the answer to that. They got it out of varying degrees of credit and currency inflation, coupled with taxation beyond anything ever dreamed of before and unprecedented regimentation of their people. In Great Britain and the United States, with their tradition of individual liberty, the heavy hand of the State has been gloved compared with the extreme methods of the totalitarian countries; but it has been there nonetheless, to a degree far beyond anything that would be tolerated in time of peace.

*The Effect of War on Business Financing: Manufacturing and Trade, World War I; by Charles H. Schmidt and Ralph A. Young, published by National Bureau of Economic Research, Inc., 1943.

When we hear it said that because this and other countries can "afford" to spend great sums for carrying on the war, we can "afford" to spend in peace, we have to bear in mind that the ultimate consequences of this war spending are not yet known. The chemist does not stop in the middle of his experiment and draw final conclusions as to the results. We have to consider, also, what we mean by the term "afford". As stated above, it is not merely a question of raising the money. It is a question of what the cost will be in terms of inflation, taxation, and the kind of an economy we are going to have.

In war, we spend money and run into debt, not because we can "afford" to in any ordinary sense, but because — compared with the supremely important objective of winning the war — almost nothing else matters. Even though we knew that the spending of these sums would eventually bring national bankruptcy and financial chaos, as it has done for many warring nations in the past, we would still do it, for the life of the nation is at stake. Not only do we accept these financial risks as a necessary part of war, but we sacrifice our liberties under all manner of government controls, and men and women leave their homes and occupations and risk their lives to defend the country's security.

In short, the economy in war is not and cannot be—at least in a democracy—a criterion for the economy in peace. War represents a tremendous distortion of normal peacetime values and practices and ways of living, and there is no warrant for assuming that because certain things are done in war they can be, or ought to be, done in peace. This applies to finance as much as to anything else. To spend money and incur debt in the desperate emergency of war is one thing. To adopt this as the regular procedure for controlling ordinary peacetime business fluctuations is quite another matter.

The Point To Be Stressed

In concluding this discussion, it should be made clear that what has been said is not to imply that the government should not give assistance in times of economic crisis. Everyone recognizes the obligation of public authorities to extend help to the needy in periods of unemployment, despite differences of opinion as to whether this should be a federal or local responsibility. Most people likewise recognize the need for government support in tiding over key situations, where time is needed to make adjustments in orderly fashion and where breakdowns might have serious and widespread repercussions. Finally, the government could help a great deal by so scheduling public works as to hold projects on the shelf when ordinary business is active, and bring them forward in times when business falls off. Such a policy would be useful both in avoiding accentuation of business peaks and in providing substantial employment and purchasing power in the valleys. It would also save money, in that projects could doubtless be carried out at less cost in periods of business slack.

In financing depression spending, few economists and experts are now such financial purists as to insist that the costs be met entirely out of taxes, and to disapprove some measure of borrowing and credit expansion as a means of mitigating deflationary pressures.

The main point to be stressed is that, whether the spending be along lines indicated above or some other, we be thoroughly aware of what we are doing, and not mistake palliatives for cures. Real curative measures consist of making adjustments, discovering and eliminating bad policies and practices, cleaning up weak spots, etc., so that the economy can get a new start. When government spending comes to be used as a substitute for such essential — though often painful and unpleasant — processes, it becomes a menace instead of a help.

Nor should it be supposed that in taking the road of government spending we are necessarily avoiding "something more radical", as suggested by Mr. Chase. Government spending tends to be like a drug, in that it takes larger and larger doses to get results; and all the time debt and taxes get higher and higher. There is no surer route to statism than by way of the tax collector, for when private enterprise ceases to become profitable and lags, the state takes over. One of the factors handicapping recovery in the 'thirties was the draining off of the sources of risk capital by taxation, together with the large slice of the profits of successful ventures taken by government.

In other words, in going forward with whatever relief programs may be deemed necessary and desirable from time to time, let us do so with eyes open to the limitations and dangers of such measures. Let us not be misled by any assumption that "because we did it in war we can do it in peace," or delude ourselves that we can keep ourselves afloat by pumping out government money for all sorts of projects, and increasing debt, so long as "the money remains in the country", and "we owe the debt to ourselves".

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